

FEEDBACK REPORT

IASB ED 2013/3 *Financial Instruments: Expected Credit Losses*

Joint Field-test by EFRAG, ANC, ASCG, FRC and OIC

19 July 2013

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EXECUTIVE SUMMARY

Overall introduction

- 1 EFRAG and National Standard Setters (ANC, ASCG, FRC and the OIC) have conducted a joint field-test whether or not the proposals for the expected credit losses model addressed the weakness of the existing incurred loss impairment model in IAS 39. Additionally, the exercise was meant to identify whether the new impairment requirements were operational, what their impact would be and the costs associated with introducing them. The exercise was focused on the practical application of the new requirements and was not intended to gather any opinions, but solely facts and objective data.
- 2 Twenty-two companies participated in the field-test, about two-thirds were from the banking industry and the remainder came from the insurance and other industries.

General approach

- 3 Most participants found the requirements under the general approach clear and the underlying principle understandable, however, they noted that more guidance and clarifications were necessary. In particular, a significant number of participants from all the industries requested further guidance around the principle of transfer, how to determine the threshold between the 12-month and the lifetime expected credit loss measurement, and the practical expedients that could be used to make the above assessment.
- 4 In addition, three participants from the banking sector felt that the wording in the ED implied that they would need to apply an explicit probability of default approach. However, not many used such an approach currently. Therefore, they suggested the change in the probability of default should be expressed as an objective rather than an absolute requirement, to make clear that other approaches could be used.

Alignment with credit risk management

- 5 Half of the participants, from the banking and insurance industry, noted that the general approach in the ED did not reflect the way they manage their portfolios since some of the elements of the proposed approach were not aligned with their credit risk management processes. In particular, some participants noted that they applied various approaches to assess credit deterioration that were not strictly based on changes in the probability of default. In addition, some participants noted that the day-one loss effect did not reflect the economics of lending because normally any initial credit loss expectations had already been priced.
- 6 However, half of the participants, mainly banks and one from other industries, indicated that the distinction between assets that had deteriorated significantly in credit quality and those that had not, was generally consistent with the way they managed their portfolios.

Assessment of a significant increase in credit risk

- 7 A significant majority of participants mentioned that the requirement to track changes in credit quality from initial recognition was operationally challenging, either because the information about initial credit quality was not available, or because the requirement was not aligned with their existing risk management processes. These comments were related to the application of the requirements once the standard had been implemented. Participants mentioning that tracking of

credit quality from initial recognition was challenging did generally not mention whether this challenge was surmountable or not.

Information considered when making the assessment

- 8 Most participants provided a wide range of information and indicators that they intended to use depending on the nature of the underlying portfolio and the level of sophistication in their internal risk management systems in order to assess whether there was a significant increase in credit risk. A few participants from the banking industry stressed that in order to reduce the operational difficulties and the associated costs, it was important that the IASB permitted to align the above assessment with their internal risk management approaches and parameters based on the Basel II methodology.

12-month and lifetime expected credit losses

- 9 Most participants identified a number of operational difficulties in applying the proposed definitions regarding the two measurement objectives in ED, including the availability of data, adjustments to their existing risk managements systems and estimating the lifetime probability of default. Only a few participants did not report any specific operational difficulty.
- 10 However, a few participants from the banking industry noted that both of the proposed expected loss measurements would be feasible for their activities under the advanced internal ratings-based approach while for other activities, both calculations would be more complex due to a lack of data. Also, the calculation of expected credit losses was considered to be operationally difficult particularly for revolving credit products and long-term products.

Operational simplifications

- 11 A significant majority of participants found the definition of 'low credit risk' clear and operational. However, a few participants found the related example in the ED confusing, and therefore, suggested the IASB to ensure that the proposed definition should not be interpreted as a bright line.
- 12 Most participants indicated that the recognition of lifetime expected credit losses would generally depend on the nature of each portfolio. For retail portfolios, the threshold would be determined by reference to delinquency information, while for wholesale portfolios, internal ratings and watchlists would most likely be used respectively. The reference to 'investment grade' would be applicable only to debt securities and counterparties assessed by rating agencies.
- 13 None of the participants identified any specific operational difficulties in applying the '30 days past due' rebuttable presumption because delinquency information was already available in their internal risk management systems. However, most of the participants argued that the proposed threshold did not necessarily reflect when there was a significant increase in credit risk, either because it was too conservative or because it was considered together with other information to make that assessment. In addition, some of those participants who argued that the '30 days past due' threshold was too short, were concerned that it would lead to excessive volatility.

Responsiveness of the general model

- 14 Most participants agreed that the proposed impairment model would be more responsive to changes in credit quality compared to the existing incurred loss model in IAS 39, therefore would allow for earlier recognition of credit losses by using forward looking information, and by requiring an allowance to be recognised

for all assets that will be subject to the proposals. However, a few participants from all the industries noted that since the proposed model essentially required the use of a *point-in-time* probability of default rather than a *through-the-cycle* probability of default, it would be highly pro-cyclical and likely to create significant volatility.

Assessing impact and costs of the ED

- 15 Many participants indicated that they were not able to access data or had significant issues accessing data for a variety of reasons. This would entail the upgrading or updating of systems and processes with reliance potentially on public historical loss data or upgrading of internal credit management procedures.
- 16 Participants were divided on whether the day one loss would have a significant impact. Eight participants (seven banks and one insurer) thought it would have a significant impact, while seven participants (three banks, one insurer and three participants from other industries) thought it would not have a significant impact. According to some participants the ED would lead to higher allowances for the banking industry.
- 17 Most participants noted that the requirements improved their ability to build an expected credit losses model. Many participants felt that the new requirements fairly reflected the performance of their lending and investing portfolios over time, while there were also many participants who did not agree with this. In making this assessment various participants compared the requirements to various other impairment models such as IAS 39, the 2009 ED, the 2011 Supplementary Document and the FASB model. The reasons why participants found that the model did not reflect the performance of their lending and investing portfolios were related to the day one loss recognition or the way they managed their portfolios.
- 18 Most participants did not feel that the application guidance was clear, operational or appropriate for all types of portfolios for a variety of reasons which are explained in detail in the body of this report. Participants strongly supported the benefits of the new ED i.e. it was seen as an improvement over the IAS 39 requirements, it allowed an earlier recognition of credit losses and for some the link to existing risk management practices.
- 19 The operational difficulties identified by participants as most important were: tracking the credit quality, estimating expected losses, estimating probabilities of default and loss rates, assessing a significant credit deterioration, having access to sufficient data, discounting expected credit losses and fulfilling the disclosures.
- 20 Participants had either not quantified the costs or were not prepared to disclose this information. The few comments about costs noted that one-off costs were seen as being high and/or significant, while ongoing costs were seen by half as being high while the other half regarded these costs as being moderate.

Application to trade receivables and lease receivables

- 21 A significant majority of participants found the requirements for trade receivables and lease receivables under the simplified approach clear. There was no clear view among participants; including those participants that had a significant exposure to these receivables, as to whether the above approach was necessary. Furthermore, there was also no clear view on whether the proposals reflected appropriately the way these receivables were managed by the participants for credit risk purposes. A few participants agreed with the requirements for trade receivables and lease receivables, either because they were already incorporating forward looking information in their estimates, or because their lease receivables were managed in a similar manner to their lending portfolio. On the other hand,

participants provided a variety of reasons as to why the requirements did not reflect how they managed these receivables.

- 22 Many participants from all the industries noted that calculating the 12-month and lifetime expected credit loss allowances for trade and leasing receivables would be challenging mainly due to the limited availability of the required data, and the requirement to consider macroeconomic forecasts as well.

Treatment of purchased credit impaired financial assets

- 23 Some participants recognised that the proposed requirements were carried over from IAS 39. Nevertheless, the same participants and many others reported operational difficulties in respect of those requirements, in particular for dealing with the credit-adjusted effective interest rate. The fact of using a different discount rate than in the general model was seen as complex.

Estimation of expected credit losses and discounting

- 24 Few participants mentioned in detail how they would calculate expected credit losses, most only provided general information. The reliance on probabilities of default in credit risk management was currently limited and hence the ability to use where possible current credit risk management to implement the ED. Few participants mentioned the difference in data availability for portfolios managed under the Advanced Internal Ratings Based Approach and portfolios not managed under this approach. For estimating expected credit losses of retail loans, participants expected to use delinquency status whilst for non-retail loans they expected to use a fixed absolute threshold (watch lists). Other methods were also mentioned which are detailed in the body of this report.
- 25 Participants from Other industries expected to use transition and migration rates based upon delinquency status or external market indicators such as credit default swaps and external ratings for estimating the expected losses for loans.
- 26 To discount expected credit losses, participants indicated using the effective interest rate, the sum of the risk free rate and the entity's spread for loans and debt securities, or the discount rates used for internal risk management purposes.

Disclosures

- 27 A significant majority of participants found the disclosures complex and overly prescriptive. The disclosure on the reconciliation of the gross carrying amount between opening and closing balance was mentioned by most participants as very burdensome to implement.

Operational problems related to the effective date and transition

- 28 Some participants indicated that paragraph C2 of the ED was not clearly worded. They noted that the paragraph seemed to suggest that if original credit quality information was not available, except for financial assets with low credit risk, lifetime expected credit losses should be recognised for all other assets at transition.
- 29 Only a few participants commented on the effective date required for the standard. Some indicated that they needed a three year implementation period, one noted that the current implementation (2015) was not realistic anymore and participants from the insurance industry requested that the implementation dates of IFRS 9 and IFRS 4, Phase II should be aligned or that insurance companies should be permitted but not required to implement IFRS 9 until IFRS 4, Phase II became effective.

INTRODUCTION

Background

- 30 On 7 March 2013, the IASB published the ED *Financial Instruments: Expected Credit Losses*. The objective of the Exposure Draft was to establish principles for the recognition, measurement, presentation and disclosure of expected credit losses that will provide useful information for users of financial statements for their assessment of the amount, timing and uncertainty of future cash flows.
- 31 The Exposure Draft proposed a consistent measurement approach for all financial assets that were measured at amortised cost and FV-OCI, including trade receivables and lease receivables. The proposed expected credit losses model aimed to reflect the credit deterioration of financial assets that will be subject to the proposals. The proposals would require entities to incorporate a broader range of information and apply judgment in order to determine their forward looking estimates and would likely affect financial and non-financial entities.

Purpose of the field-test

- 32 EFRAG and National Standard Setters have conducted a joint field-test on whether or not the proposals for the expected credit losses model addressed the weaknesses of the existing incurred loss impairment model in IAS 39. Additionally, the exercise was meant to identify whether the new impairment requirements were operational, to assess their impact and to identify the costs associated with introducing them. The exercise was focused on the practical application of the new requirements and was intended to solely gather facts and objective data. In particular, the field-test asked questions on:
- (a) How the expected credit losses model reflects the amount, timing and uncertainty of future cash flows;
 - (b) Whether the requirements are clear and operational;
 - (c) The impact of the proposed expected credit losses model; and
 - (d) The costs and benefits of the proposed expected credit losses model.
- 33 The field-test was intended to help EFRAG and the National Standard Setters formulate their views on the impacts of the application of the proposed impairment requirements in IFRS⁹ and to serve as input to the European Commission's endorsement process.
- 34 In describing the findings the following denominations are used in this report:
- (a) Some/few: from 2 to and including 7 participants;
 - (b) Many: from 8 to and including 12 participants;
 - (c) Most: more than 12 participants;
 - (d) Significant majority: 17 participants or more.

Workshops

- 35 In addition to this questionnaire, EFRAG and the National Standard Setters had prepared workshops for each industry involved. Due to a lack of interest and case studies, only one workshop was organised.

- 36 On 10 June 2013 a workshop was organised in which participants from the banking and insurance industry took part. Also the IASB was present. Participants submitted eight case studies that were discussed with the staff of EFRAG, National Standard Setters and the IASB. The findings from this workshop are summarised in Appendix B.

Coordination with the IASB outreach

- 37 Next to the field-test organised by EFRAG and the National Standard Setters, the IASB has also organised a field-test which had as a purpose the measurement of how the impairment model would behave in different economic environments. The IASB field-test was organised on a global level and thus not limited to European constituents. In setting up this field-test exercise, EFRAG and the National Standard Setters have coordinated with IASB staff in order to avoid unnecessary overlap in their respective outreach activities. EFRAG and National Standard Setters shared their draft questionnaire at the initial design stage with the IASB staff and took their suggestions and recommendations into account.

Companies that participated in the field-test

- 38 Twenty-two (22) companies participated in the field-test. The table below summarises the number of participants by country and by industry.

<i>Participants by country:</i>		<i>Participants by industry:</i>	
France	4	Banking	15
Germany	5	Insurance	2
Italy	4	Other industries	5
Luxemburg	2		
Spain	2		
Undisclosed	1		
UK	4		
	<u>22</u>		<u>22</u>

- 39 The list of participants is included in the Appendix A of this document.

DETAILED RESULTS

- 40 The field-test exercise was focused on the practical application of the new requirements and was not intended to gather any opinions but solely facts and objective data.

GENERAL APPROACH

Clarity of the requirements

- 41 Most participants found the general approach for measuring expected credit losses clear and the underlying principle understandable, however, they noted that more guidance and clarifications were necessary and provided a number of suggestions to address their concerns.

Significant increase in credit risk

- 42 Most participants from all the industries requested further guidance around the principle of transfer, how to define the threshold for the recognition of lifetime expected credit losses, and the practical expedients that could be used to make the above assessment. One participant noted that other than the indicators described in paragraph B20 of the ED, the ED did not provide much guidance on the different issues regarding the assessment.

- 43 In particular, these participants provided the following comments and suggestions to make the assessment easier and more aligned to their existing credit risk management methodologies:

- (a) The relative approach in the ED would be operationally very hard to implement and would not be completely aligned with the existing credit risk management practice which used a wide range of indicators (not only probability of default) to assess credit deterioration. Paragraph 8 of the ED: The change in the probability of default should be expressed as an objective rather than as an absolute 'shall';
- (b) Paragraphs 8 and B14 of the ED: As a practical expedient the standard should allow a direct comparison of the 12-month probability of default at initial recognition and the reporting date without further consideration of the term structure; Paragraph B11 of the ED: The standard should clarify in what circumstances the 12-month probability of default was likely to be consistent with the objective stated in paragraph 8 of the ED;
- (c) The standard should clarify why the practical expedients in the ED meet the requirements in order to help preparers develop their own methodologies; More guidance should be provided on the concepts of 'significant credit deterioration' and 'default' which would require considerable judgment;
- (d) The definition of 'low credit risk' was not clear and some of the terms used in the definition could not be interpreted from a risk management perspective. The objective associated with the descriptions used should be clarified;
- (e) Paragraph B21 of the ED: When developing a sophisticated approach which incorporates several factors such as macro-economic forecasts into determining the probability of default, the loss given default and the exposure at default, one should include additional judgmental overlays which attempt to adjust for the same macro-economic factors. This would result in double counting. The paragraph could also point out that additional

judgmental overlays should not be added without evidence, which would be contrary to the framework in order to avoid being too prudent or being in a position to manipulate results.

Operational simplifications

- 44 A few participants from the banking and insurance industry provided the following comments on the 'investment grade' and '30 days past due' simplifications:
- (a) The combination of the relative and absolute elements added complexity, while in practice credit deterioration was mainly based on absolute elements;
 - (b) The 'investment grade' threshold should not be interpreted as a bright line. In addition, one participant from the other industries mentioned that the standard should clarify how to deal with portfolios where the internal definition of low risk could not be aligned with the external definition of low risk; and
 - (c) On the '30 days past due' presumption, one participant from the other industries, noted that the ED was not clear whether the simplification should be applied in general or only when delinquency information was used.

Definition of probability weighted amount

- 45 The definition of the 'probability weighted amount' was not clear to one participant from the other industries. In particular, the standard should clarify how the proposed definition related to the definition of an 'expected value' under IAS 37.

Alignment with credit risk management

- 46 Half of the participants, from the banking and insurance industry, noted that the proposed general credit deterioration approach in the ED does not fully reflect the way they managed their portfolios since some of the elements of the proposed approach were not aligned with their credit risk management processes.
- 47 In particular, a few participants mentioned that the day-one loss effect as a result of recognising the 12-month expected credit loss allowance, did not reflect the economics of lending, because normally any initial credit loss expectations would have already been priced.
- 48 In addition, three participants noted that the requirement to recognise lifetime expected credit losses based on changes in the probability of default was also not consistent with the way they managed their portfolios for credit risk purposes. According to their existing risk management processes, lifetime credit losses were recognised based on changes in internal ratings (i.e. once the credit quality of the asset reached an absolute level of credit risk), or only after the bank had taken necessary actions to ensure recoverability of cash flows (e.g. new guarantees, reduction of exposure).
- 49 Three other participants noted that the proposed approach in the ED was not consistent with their credit risk management processes which were currently based on the existing incurred loss model in IAS 39.
- 50 However, half of the participants indicated that the distinction between assets that had deteriorated significantly in credit quality and those that had not, was generally consistent with the way they managed their portfolios for credit risk purposes (i.e. the good book/bad book distinction). Furthermore, two of those participants, confirmed the link between credit risk and pricing at initial recognition.

Assessment of a significant increase in credit risk

51 A significant majority of participants mentioned that the requirement to track changes in credit quality from initial recognition was operationally challenging. They provided the following reasons for this:

Table 2: Difficulties in tracking credit quality from initial recognition

Limited availability of historical defaults	<ul style="list-style-type: none"> • Historical probability of default information was limited and could not be met for a significant part of participant's portfolios. • While credit deterioration could be assessed by banks that were following the Advanced Internal Ratings Based (AIRB) models, these models had only been recently applied, therefore tracking was difficult for loans that have not been issued recently. • For the new loans, significant IT investments would be required in order to align the regulatory approach with the accounting proposals as the information was not available or updated on a regular basis. • Risk management was more focused on changes in various performance indicators or absolute credit risk of the counterparty rather than changes in probabilities of default
Comparison of marginal probabilities of default	<ul style="list-style-type: none"> • The requirement in paragraph 8 of the ED which implied storage of the full set of marginal historical probabilities of default at originations for each overdraft or deferred payments provided to a customer in the portfolio was complex and very costly to implement; • The assessment of credit deterioration should not be limited to the comparison of probabilities of default.
Ratings were not fully comparable	<ul style="list-style-type: none"> • The ratings at initial recognition and at the reporting date were not always fully comparable due to periodic revisions made in the Advanced Internal Ratings Based models to adapt for changes in the economic environment and the clients' status.
Other operational difficulties	<ul style="list-style-type: none"> • The estimation, updating and assessment of shifts in probabilities of default was considered burdensome; • The need to continuously validate and back test the calculations was considered to be burdensome; • The significant amount of data that needed to be processed lead to significant changes in risk management systems

52 The table below summarises the main reasons that participants mentioned why the assessment was specifically operationally difficult for each of their portfolios:

Table 3: Operational difficulties per type of portfolio

<i>Retail portfolios</i>	<ul style="list-style-type: none"> Tracking at the individual level was not possible because information about credit quality was not stored at the client level Original probability of default was not required for Basel II purposes; the possibility to use delinquency information would be important Large number of retail clients Operationally challenging especially for long-term products like mortgages
<i>Wholesale portfolios</i>	<ul style="list-style-type: none"> Tracking at the individual level was not possible because information about credit quality was not stored at the client level
<i>Loan commitments and financial guarantees</i>	<ul style="list-style-type: none"> Difficult to refer back to the origination date and conditions especially for revolving credits
<i>Investment portfolio</i>	<ul style="list-style-type: none"> Information about probabilities of default could be obtained from external ratings, but was not readily available Tracking exercise would become complex if some debt securities or other instruments issued by the same counterparty were classified at different stages

Information considered to make the assessment

- 53 Most participants provided a wide range of information and indicators that they intended to use depending on the nature of the underlying portfolios and the level of sophistication in their internal risk management systems, in order to assess significant credit deterioration.
- 54 Participants generally noted that they would mainly use the following information and indicators (including the information provided in the application guidance of the ED) described below to assess whether there was a significant increase in credit risk in their portfolios:

Table 4 Methods currently used to assess credit deterioration

<i>Retail portfolio</i>	<ul style="list-style-type: none"> Delinquency status and behavioural scorings Objective evidence of impairment (IAS 39 criteria) Internal and external ratings
<i>Wholesale portfolio</i>	<ul style="list-style-type: none"> Watch-lists Internal ratings
<i>Investing portfolio</i>	<ul style="list-style-type: none"> Internal and external ratings

- 55 In addition, two participants from the banking industry noted they were considering how to include changes in macroeconomic conditions in their assessment. These participants suggested that such changes should not automatically result in transfers of assets into stage-2. A few participants from the banking and the other industries indicated that they would use their existing Internal Ratings Based models to make the above assessment.

12-month and lifetime expected credit losses

- 56 Most participants identified a number of operational difficulties in applying the proposed definitions regarding the two measurement objectives in ED, including among other, the availability of data, adjustments to their existing risk managements systems and estimating the lifetime probability of default. Only a few participants did not report any specific operational difficulty.
- 57 However, a few participants from the banking industry noted that both of the proposed expected loss measurements would be feasible for their activities under the Advanced Internal Ratings Based approach , while for the other activities, both calculations would be more complex due to the lack of data.
- 58 Overall, the calculation of expected credit losses was considered to be operationally more difficult for revolving credit products and long-term products.

General comments

- 59 Participants from all the industries, provided the following general comments related to both of the above measurements:
- (a) Allocation of provisions between balance sheet and off-balance sheet items would be operationally challenging;
 - (b) Few participants noted that adjusting the regulatory parameters to comply with the definitions in the ED would be operationally difficult. In particular, one participant (a bank) noted that the advanced Internal Ratings Based models were based on through-the-cycles probabilities of default, whereas the ED required the use of point-in-time estimates. In this respect it would be important to align the ED to the risk management methodologies to avoid they had to change these.
 - (c) Few participants noted that applying a standardised definition of 'default' to the different individual portfolio characteristics would be difficult;
 - (d) Model development and data requirements will involve considerable implementation effort;
 - (e) Greater clarity should be provided in respect of provisioning for revolving credit products which could often be withdrawn at short notice.
- 60 One participant from the banking industry added that the contractual term for some credit card portfolios could be as little as one day for both undrawn commitments and existing balances. That participant was concerned that basing impairment allowances on contractual terms, where these were less than the behavioural life of the loan, could be contrary to users' reasonable expectations of the new models.
- 61 Furthermore, it would also result in outcomes for which no actual loss experience existed on which to base estimates since in practice facilities were not immediately withdrawn. The participant noted that it was reasonable to assume a 12-months life for credit cards since balances that had demonstrated a significant increase in credit risk, usually progressed to write-off within 12 months. Therefore, the participant suggested the IASB should reconsider the approach for such situations.

12-month expected credit losses

- 62 In addition to the general comments described above, some of the participants provided the following comments regarding the implementation of the requirement to calculate 12 month expected credit losses.
- (a) A few participants from the banking industry argued that the definition of 12 month expected credit losses was operational when applied under the existing Basel II requirements; while one of them emphasised that in order for the definition to be operational it was necessary to allow the regulatory definitions to be used.
 - (b) One participant from the other industries noted that the 12-month expected credit loss allowance seemed more difficult because of the required level of precision in the calculation. Nevertheless, two of those participants stressed the importance of being able to use the Basel II parameters, and that they should be allowed to estimate loss given default by discounting cash flows to the date of default and not the reporting date; and
 - (c) One participant from the insurance industry accepted that the above measurement was a compromise; however it should not be replaced by the concept of 'foreseeable future' which was not well defined and could lead to inconsistencies in application and unnecessary volatility.

Lifetime expected credit losses

- 63 Some of the participants provided the following comments regarding the operational difficulties related to the lifetime expected credit loss measurement:
- (a) The maturity in long-term loans would be a source of operational difficulties. One participant from the banking industry requested an operational simplification and noted that an operational relief could be obtained if the period for the estimation of expected credit losses was shortened from the contractual maturity to the period where the majority of losses was expected;
 - (b) Another participant from that same industry added that the estimation of lifetime expected credit losses would require significant data requirements for long-term products and it was not clear whether the information would be meaningful and auditable;
 - (c) The calculation of the lifetime credit loss allowance would require bridges to be developed between the accounting and the risk management systems;
 - (d) Calculation of the lifetime probability of default would be difficult for the IT systems. One participant from the other industries added that the required data to perform the above calculation was partially available, and that new probability of default models would need to be implemented where there was limited experience to develop such models;
 - (e) One participant from the insurance industry noted that the transition to the lifetime expected credit loss measurement was operational, since ratings were available for most assets, however implementation was complex. One participant from the banking industry added that movements between stages were made on the transaction level whereas for risk management purposes credit risk was monitored on a counterparty level;

- (f) In addition, that participant noted that calculating a multiyear expected loss would lead to some difficulties mainly due to the estimation of the exposure at default, especially for all the exposures without amortising cash flows.
- (g) Determination of: expected values for renewals, net present value of gross recoveries, and standard costs or expense ratios for the application of collaterals;
- (h) Consideration of the economic cycle and Accounting definition of the term of a transaction;

Operational simplifications

'Low credit risk'

Clarity and operability

- 64 A significant majority of participants found the definition of low credit risk clear and operational. However, one participant from the other industries noted that the proposed definition was neither clear nor operational. Although that participant found the reference to 'investment grade' as an example helpful, he explained that mapping internal ratings to external ratings was difficult, because internal definitions of default typically did not match the definitions applied by external ratings.
- 65 In addition, two participants from the banking industry found the definition clear but operationally difficult to apply. One of them noted that it would be complex to develop a model based on that definition because it would be challenging to define and quantify 'adverse economic conditions' that will lead to credit deterioration. The other participant added that the definition would be operational only for exposures treated under the Advanced Internal Ratings Based approach.
- 66 A few participants (banks and insurers) provided the following comments and suggestions regarding the above definition:
 - (a) The example in paragraphs IE16-IE21 of the illustrative examples was very confusing and subject to different interpretations. The standard should ensure that the examples were only for illustrative purposes and not misinterpreted as setting bright lines; and
 - (b) The standard should clarify that the low credit risk threshold was similar to the 30 days past due rebuttable presumption rather than a bright line.

Application to different portfolios

- 67 Most participants generally felt that the proposed definition would be applicable only to debt securities and counterparties assessed by rating agencies, rather than to retail portfolios where delinquency information would be more relevant to assess changes in credit risk. One participant from the banking industry added that credit risk could not be considered 'low' at the same level for different portfolios, as it depends on the risk appetite a bank has in each single portfolio segment. Therefore, the standard should allow each entity to identify different 'low' credit risk thresholds according to the characteristics of each portfolio. Another participant from the banking industry noted the definition of investment grade, when applied to the credit market, should be adapted to the specific product markets, as it was not necessarily the same for different banks in different markets.

- 68 Three participants from the banking industry responded that the proposed definition would be applicable to all types of portfolios and that they would need to investigate for their retail portfolios the 'equivalent to low credit risk' concept.

Alignment with credit risk management

- 69 Most participants from the banking, insurance and other industries indicated that the recognition of lifetime expected credit losses would generally depend on the nature of each portfolio. In particular, participants noted that most likely, for retail portfolios the threshold would be determined by reference to delinquency information, whereas for wholesale portfolios, by reference to internal ratings and watchlists respectively.
- 70 One participant from the banking industry noted that for all portfolios the level of credit risk that justified the recognition of lifetime expected credit losses was the 'non-low credit risk grade', while another participant from the same industry added that lifetime expected credit loss would correspond to the level of credit risk beyond which a bank would not normally originate new loans. In addition, a third participant from the same industry noted that the definition of 'low credit risk' had been consistently applied to the rated bond market and therefore a unique threshold could be applied at a group level.
- 71 However, one participant from the banking industry suggested that the definition of low credit risk should be summarised as 'the rating level above which institutional investors have been authorized to invest' thus creating a direct linkage, well recognised by all market constituents, between investment policies and securities on which investments could be made.

30 days past due

- 72 None of the participants identified any specific operational difficulties in applying the 30 days past due requirement because delinquency information was already available in their internal risk management systems. In addition, the significant majority of the participants agreed that delinquency information was the most meaningful approach to reflect the clients' payment behaviour for retail portfolios. However, most of the participants argued that the proposed threshold did not necessarily reflect when there was a significant increase in credit risk, either because it was too conservative (i.e. simply due to technical delays in payments) or because it was considered together with other information, including behavioural scoring, to make that assessment.
- 73 In particular, some of those participants (from the banking and the other industries) noted that the proposed threshold was too conservative, and therefore could lead to excessive volatility. Some participants felt that a longer period would be more appropriate (60-days or 90-days) and consistent with the way they currently managed these receivables for credit risk. One participant (a bank) suggested that the standard should allow entities to identify the appropriate threshold based on their internal rating system. Therefore, the appropriate threshold would depend on the characteristics of the counterparty and the nature of each portfolio.
- 74 A few participants from the banking industry noted that although the proposed threshold was a reasonable backstop, it was a lagging indicator that should be used in isolation only in the absence of more forward looking information. Finally, two other participants from the banking and the other industries noted that the 30 days past due threshold would generally reflect when there was a significant increase in credit risk.

Responsiveness of the general model to changes in the economic environment

Comparison with IAS 39

- 75 Most participants agreed that the proposed impairment model would be more responsive to changes in credit quality compared to IAS 39, and therefore would allow for earlier recognition of expected credit losses for the following reasons:
- (a) By using forward looking information as opposed to incurred loss events;
 - (b) By recognising an allowance for credit losses for all assets which was considered to be higher than the incurred but not reported loss;
 - (c) The ‘trigger event’ for calculating lifetime expected credit losses was brought forward (i.e. significant credit deterioration versus objective evidence of impairment);
- 76 However, one of those participants from the banking industry noted that the answer would depend on how entities interpreted incurred but not reported losses. Six participants indicated that they were still assessing the proposals and therefore were unable to respond to this question.

Deteriorating economic environment

- 77 A significant majority of the participants generally agreed that under a deteriorating economic environment the proposed impairment model would lead to earlier recognition and higher allowances for credit losses. In addition, some of those participants observed that under such economic environment more assets or portfolios would be considered to have deteriorated significantly as a result of falling credit ratings and other market indicators.
- 78 A few participants from all the industries noted that by using a point-in-time probability of default instead of a through-the-cycle probability of default, the proposed model would exhibit high pro-cyclicality creating significant volatility and a directional effect strictly based on the economic cycle.

Positive economic environment

- 79 A significant majority of participants noted that generally the effects described above in a deteriorating economic environment would likely reverse and overall the level of allowance would fall. However, some of these participants mentioned that the positive effect would be offset by the recognition of the 12-month expected credit loss allowance for all new loans. Therefore, the overall impact would depend on the relative product mix and growth rates.
- 80 With respect to the 12-month expected credit allowance, one participant from the banking industry noted that a growing portfolio would result in an increase of allowances that reflected a volume effect, while another participant from the same industry added that this might result in more conservative lending policies. That participant also noted that reflecting improvements in economic conditions would require robust and supportable data that in practice would likely incorporate prudence.
- 81 One participant from the insurance industry argued that under positive economic conditions, there was a risk the assessment could result in insufficient allowances that would not cover actual losses in the future. Finally, one participant from the banking industry, mentioned that the proposed model would allow entities to better prepare by anticipating changes in the economic cycle if the economic environment was about to change from positive to negative.

Purchased credit impaired financial assets

- 82 A majority of participants found the requirements for purchased credit impaired financial assets clear or clear enough. Some participants asked for clarifications or indicated that this part was not applicable to them.
- 83 Although a few participants recognised that the proposed requirements were carried over from IAS 39, the same participants and many others reported operational difficulties in respect of those requirements, in particular for dealing with the credit-adjusted effective interest rate. One participant acknowledged that following the comments on the 2009 ED, the IASB had changed its approach from an expected cash flow to an expected loss approach. Nevertheless, the participant noted that the expected loss would be calculated as a present value, thus reflecting the time-value of money. Calculating the credit-adjusted effective interest rate required determining “undiscounted” credit-adjusted cash flows and discounting them in order to arrive at an effective interest rate. As the expected loss was a discounted figure already and has been discounted with a certain fixed interest rate, it would be methodologically inconsistent to use this discounted figure when calculating a credit-adjusted effective interest rate.
- 84 One industry participant noted that it was not clear whether the initial impairment related to purchased or originated credit related impaired trade receivables should be presented in a separate line item “impairment gains and losses” of profit or loss and other comprehensive income. The participant also asked clarification whether revenues would continue to be recognised according to IAS 18, i.e. at the fair value of the consideration received or receivable.
- 85 For the issues identified above, two participants indicated to prefer the FASB proposal for purchased credit impaired financial assets. Some participants asked for a practical expedient, when impairment was estimated to be temporary and for short term financial assets. One participant noted that the proposed requirements partially reversed the decoupling of interest income and credit losses, which was not supported.
- 86 Few participants noted that it was unclear when assets would be originated that were credit-impaired. It was considered helpful if the IASB were to set out the circumstances under which entities were to assess whether they had originated credit impaired assets. In addition to the above, it was noted that the ED carried forward – with little change, other than to remove the “incurred but not reported” language – the existing IAS 39 criteria for objective evidence of impairment. The reason for this was that entities following IFRS already have systems in place to meet IAS 39 requirements for identifying financial assets to which net interest recognition is applied, little additional complexity was involved in maintaining these systems. One participant was not convinced this was the case. Implementing these proposals could require significant new systems development and entities may have to extend these new systems to address a further sub-component of loans for which life time loss recognition was appropriate rather than just maintaining existing practice.
- 87 One of the main criticisms of IAS 39 impairment provisions was that the triggers were applied inconsistently in practice. According to one participant it was inappropriate to just bring forward the IAS 39 criteria without review to ensure that they could be adequately differentiated from the indicators in paragraph B20 of the ED. That participant noted that, if the IASB changed the definition of the point where objective evidence of impairment exists to better align with the indicators in paragraph B20 of the ED, perhaps aligning the point where objective evidence of impairment exists with default, this would have a knock on impact on when a purchased or originated loan would be credit impaired.

Estimation of expected credit losses and discounting

- 88 Few participants mentioned in detail how they would calculate expected credit losses. A significant majority provided only general information. Those from the banking industry indicated that they would base their approach on existing Basel II estimates and apply corrective factors to comply with the IFRS 9 requirements. Few participants from the banking sector indicated that while for portfolios under the Advanced Internal Ratings Based approach internal indicators were available, this was not so for the portfolios which were not managed under this approach.
- 89 One participant from the banking sector indicated that they would rely solely on the delinquency status for retail loans and on a fixed absolute threshold for non-retail loans. Another participant from the banking sector indicated that they would use internal ratings based on counterparty characteristics and behavioural data for individuals, balance sheet and income statement for corporates. Another participant from the banking sector indicated the following. The unsecured approach for 12 month expected loss used roll-rates combined with lifetime loss rates to calculate lifetime expected losses for accounts that rolled into stage 2 in the next 12 months. The approach for lifetime expected loss accounts used cash flow based lifetime expected losses.
- 90 A participant from the banking industry which indicated its intention to build upon existing Basel II estimates added the following estimation techniques to be used:
- (a) Qualitative and judgmental corrections of statistical outcomes;
 - (b) Use of discounting, preferably at the effective interest rate;
 - (c) Using practical expedients such as the 30 days past due rebuttable presumption but used as a backstop;
 - (d) Choosing the appropriate measurement level; and
 - (e) Choosing the appropriate measurement period for expected losses for revolving loans.
- 91 One participant from other industries, indicated that they would use transition and migration rates between the delinquency status, or external market indicators such as credit default swaps and external ratings for estimating the expected losses for loans. For trade receivables some participants indicated that they would use provision matrices.
- 92 Also, some participants mentioned in detail how they would make use of the accounting policy choice for discounting expected credit losses. Some participants indicated that they would use the effective interest rate. One participant from other industries noted to use the sum of the risk free rate and the entity's spread for loans and debt securities. Few participants from the banking sector indicated to the likely use of the discount rates in their internal risk management based on Basel II requirements.

Disclosures

- 93 Most participants found the following disclosures complex and overly prescriptive:
- (a) Reconciliation between opening and closing balance of the gross carrying amount (seven participants);
 - (b) Write-offs (one participant);

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- (c) Modified financial assets (three participants);
 - (d) How default was defined (one participant);
 - (e) Estimation techniques, changes in estimation techniques and the reason for such changes (three participants);
 - (f) Discount rate used (two participants);
 - (g) Collateral information (three participants);
 - (h) How the 30 days past due presumption was rebutted (one participant); and
 - (i) Disclosures by credit risk grades (four participants).
- 94 One participant from other industries found that the disclosures would give insight into business details that were commercially sensitive.
- 95 A participant from the banking industry believed the disclosures should be aligned with IFRS 7, the Enhanced Disclosure Task Force framework and the Basel III credit disclosures. Another participant from the banking industry added that different disclosures were at the moment requested by different regulators (IFRS 7, Basel Pillar III, the European Securities and Markets Authority, the Financial Stability Board enhanced disclosure task force and the European Banking Authority) with significant stratification and potential redundancy. One participant from the banking industry asked to clarify the proposal to satisfy the disclosures by cross-referring to another document in paragraph 32 of the ED. When disclosures were to make cross-references to reporting frameworks which were not audited today, clarification was asked whether these other reporting frameworks should be audited in the future also.

Effective date and transition

- 96 A few participants indicated to need a three year implementation period, one participant indicated that the current implementation date for IFRS 9 was not realistic anymore, participants from the insurance industry requested to align the implementation dates of IFRS 9 and IFRS 4, phase II or indicated that insurance companies should be permitted but not required to implement IFRS 9 until IFRS 4, phase II came into play.
- 97 A few participants indicated that paragraph C2 of the ED was not clearly worded and seemed to suggest that, apart from financial assets that were of low credit risk, lifetime expected losses should be recognised for all other assets at transition if original credit quality information was not available. A few participants noted that they should be allowed to use the '30 days past due' rebuttable presumption to avoid the application of lifetime expected credit losses. A practical expedient to choose different definitions of low credit risk was requested to provide transitional relief by one participant.
- 98 A participant from other industries with a financial services division described the following main challenges in implementing the standard:
- (a) Complexity: the participant noted that its accounting methodology would change in an important way as a result of the proposed standard. The approach was also considered to be written for fully fledged banks with regulatory risk parameters in place, sophisticated risk management methods and systems and advanced modelling skills which smaller financial services providers and industrial preparers do not have available;

- (b) Alignment with regulatory Basel requirements: the gaps between the ED requirements and the Basel requirements added additional complexity;
 - (c) Data: the data requirements, including data history, could not be met for an important part;
 - (d) Forecasting: estimating macro-economic forecasts was seen to be very difficult and possibly leading to misleading results. A qualitative approach was preferred.
 - (e) Decoupling: the treatment of purchased credit impaired assets partially reversed the IASB decision with regard to decoupling of interest and expected credit losses, leading to additional costs;
- 99 A participant from the banking industry provided an overview of the main challenges in implementing the standard:
- (a) The estimation of robust term structures of probability of defaults (and possibly of loss given defaults) which required long time series of internal data;
 - (b) Tracking of creditworthiness of each single exposure, the complexity of which was aggravated by the periodic maintenance of the internal models, which introduced discontinuities in the time series. While this comment came from one participant, many participants confirmed in their answers the difficulties with tracking of credit risk;
 - (c) Calculating the present value of expected losses on each single expected cash flow which was seen as computationally highly intensive.
- 100 Another participant from the banking industry noted that it was not clear which processes would be required to validate internal estimates used for accounting purposes. Also, new processes for signing-of multi-year macro-economic scenarios were expected. A participant from other industries noted the requirement to calculate the interest income in three ways (original effective interest rate on the gross carrying amount, original effective interest rate on the net carrying amount and the credit-adjusted effective interest rate on the net carrying amount) as the major operational difficulty of the ED.
- 101 Another participant from the banking industry noted that retrieving rating information at inception was difficult for those ratings which were built on qualitative information the original information was no longer available. Also the economic characteristics of the counterparty could have changed over time (e.g. an evolution from small and medium sized company to a corporate), in which cases the last rating system assigned were to be adopted.

Modifications and write-offs

- 102 On the application of the impairment model to modified financial assets, some participants saw little or no difference between current practices following IAS 39 and the new requirements. Some participants saw important operational problems in implementing the requirements. The operational problems highlighted were related to the identification of modified financial assets and the recalculation of the gross carrying amount on the basis of the modified cash flows.
- 103 On write-offs not many comments were received. A few participants noted that the write-off policy was connected to the legal requirements in a specific jurisdiction which made it difficult to establish one overall company policy and affected the comparability of the policies across jurisdictions.

APPLICATION TO TRADE RECEIVABLES AND LEASE RECEIVABLES

Simplified approach

Clarity of the requirements

104 A significant majority of the participants found the requirements for trade receivables and lease receivables under the simplified approach clear. Agreement was based on practical reasons since under the above approach they would not be required to track changes in credit quality to assess a significant increase in credit risk. Five of those participants indicated that these receivables represented a significant portion of their business activities. However, one participant with a relatively large exposure in lease receivables and trade receivables, disagreed as the term 'lease receivable' was currently not defined under IAS 17 *Leases*.

Need for a simplified approach

105 Participants were generally divided as to whether the simplified approach was necessary, including those participants to whom these receivables were relatively significant for their activities. In addition, many participants did not provide specific input mainly because these receivables were relatively less important for them.

106 Seven participants of the banking industry and other industries did not find the simplified approach necessary. In particular, some of those participants argued that lease receivables were already treated in their risk management systems in a similar way to their lending portfolio. In addition, some of them noted that the expected benefit would be limited for trade receivables due to their short-term nature and therefore, the 12-month expected credit loss and the lifetime expected credit loss allowance would be identical. In addition one participant from the banking industry, noted that if the standard made clear that for these receivables delinquency would be a criterion of credit risk deterioration (and not just a practical expedient) then there would be no need to distinguish between a simplified approach and the general approach..

107 One of the participants with a relatively high exposure to these receivables – that did not find the simplified approach necessary – added that the challenge under the proposed impairment model was the calculation of the lifetime expected credit losses which was nevertheless still required under the simplified approach. That participant suggested an operational simplification whereby the allowance for trade receivables would be measured at the 12-month expected credit loss for all trade receivables. The basis for this proposed simplification was because the implementation of lifetime probability of default for a minor part of the portfolio which had an original lifetime of more than one year would result in limited value and would require undue cost and effort.

108 However, six participants from all the industries argued that the simplified approach was a reasonable and appropriate simplification that would make the assessment easier avoiding the need to track changes in credit quality from initial recognition. In addition, a few of the those participants noted that the estimated impact would not be significant due to the short-term nature for most of their existing trade receivables.

Alignment with risk management

109 Nearly half of the participants did not provide any specific input on whether the requirements were aligned with the way they managed these receivables, mainly because these receivables were not relatively important to their business. Seven

participants agreed that the requirements for trade receivables and lease receivables reflected appropriately the way they managed these receivables for credit risk purposes. Agreement was either because lease receivables were managed in a similar manner to their lending portfolio, or because forward looking information was already considered to estimate credit losses for their trade receivables. Three of the above participants had a relatively significant exposure to these types of receivables.

- 110 However, a few participants from the banking and the other industries specifically noted that the simplified approach did not fairly reflect the way they managed these receivables for a variety of reasons. In particular, for trade receivables, a participant from the other industries noted that although a provision matrix was used to calculate credit losses, the amount was based only on the overdue amounts. In addition, one participant from the banking industry noted that for factoring receivables, risk management practices varied and credit risk was monitored either at the client level or at the receivable level.

12-month and lifetime expected credit losses

- 111 Many participants from all the industries indicated that estimating 12-months' and lifetime expected credit losses respectively, would be operationally challenging. These challenges related mainly to the amount, availability and processing of data in order to implement the new requirements. One of those participants from the banking industry noted that there were significant operational difficulties but they were capable of being addressed in a practical manner.

- 112 More specifically, these participants highlighted the following main operational difficulties:

- (a) Historical data was generally not available and would require significant effort to gather and process;
- (b) Estimating the up-front reserve on trade receivables and lease receivables that were not yet overdue;
- (c) Calculation of expected credit losses for trade receivables was not currently required both for the regulated and non-regulated part of the portfolio;
- (d) Estimating the 12-months' and the lifetime expected credit losses at the individual level was very challenging since probability of default and loss given default (LGD) information was typically not available for non-regulated portfolios;
- (e) Calculating a reliable probability of default curve in the absence of sufficient data, as participants would otherwise found their calculations on purely hypothetical calculations with no underlying facts; and
- (f) Including future expectations based on macroeconomic forecasts. One participant with a relatively significant exposure to trade receivables and lease receivables, noted that such a requirement would result in disproportionate effort and limited value added due to the difficulties with macro modelling in terms of the stability of estimates and the statistical significance of parameters;

- 113 However, a few participants noted that they did not identify any particular operational difficulty because they were currently estimating expected credit losses for internal risk management purposes (banking industry) and due to the short-term nature of their trade receivables (other industries).

Information considered to assess a significant increase in credit risk

- 114 Nearly half of the participants did not specifically describe the indicators and information that they intended to use to assess whether there was a significant increase in credit risk for these receivables, mainly because they were relatively insignificant to their business.
- 115 A few participants from the banking industry indicated that they will use the same indicators and information they currently used for their lending portfolio. In addition, some participants mentioned that they would mainly use for the above assessment the following information: delinquency information, internal ratings and behavioural scores, the existing IAS 39 incurred loss indicators, and the indicators listed in the ED.

Discount rate

- 116 Half of the participants did not specifically provide any feedback on discounting in the context of trade receivables and lease receivables due to the low relative significance of these receivables in their overall portfolios. However, four participants noted that they would likely use the effective interest rate in order to discount trade receivables for different reasons. In particular, these participants argued that the effective interest rate was the more appropriate rate to discount expected credit losses and reflect the time value of money mainly because:
- (a) Any other rate would be subject to significant judgement that would result in potential volatility purely due to changes in the discount rate; and
 - (b) The effective interest rate was in most cases available in their IT systems.
- 117 One participant for whom these receivables were relatively significant, noted that discounting expected credit losses for short-term receivables would result in an increased implementation effort and the difference was considered to be immaterial. Consequently, the participant suggested that a practical expedient of exemption from having to discount credit losses for receivables with a maturity of less than a year might be helpful.
- 118 Three participants from all industries supported the use of the risk free rate for operational reasons as the use of the effective interest rate to open portfolios was not operational.

IMPACT AND COST ASSESSMENT

Access to data

- 119 Seven participants indicated that they would have access to the required data to update their historical loss information. Eleven participants indicated that they would not be able to access this data or would have significant issues accessing this data. Four participants provided no answer to the question.
- 120 The participants who were not able to access the data or would have significant issues accessing the data provided a variety of reasons. A participant from the banking industry indicated that including reasonable and supportable forecasts of future events and economic conditions in their estimates was one of their main operational concerns and credit losses estimation was a very expert judgemental area that would be even more so with the requirement of including forward looking information. A second participant in the banking industry mentioned several difficulties that may be encountered. For example, that data was not available on all activities; for entities under the Internal Ratings Based approach loss information was available, but as economic recoveries could take several months

to several years to materialize it was always difficult to have recent updates of historical loss data and to be able to make reasonable forecasts; macro-economic scenarios did exist, but they had a limited horizon.

- 121 Another participant from other industries, indicated that the incorporation of macroeconomic expectations for example into modeling increased the complexity of estimates and was expected to be of limited benefit in reality, one reason being provided for this was that correlations changed or new influencing factors could arise especially in times of crisis. It was also stressed that valid statistical correlations were not available for all portfolios and they would be forced to restrict adjustments for future events and economic conditions to management adjustments that reflect corresponding expectations.
- 122 Of the participants indicating that they did have access to data, one participant from the banking industry reported that the regulatory regime requires Advanced Internal Ratings Based banks to collect historic data to regularly validate and re-calibrate risk parameters used to determine risk weighted assets and expected life. The required information was already considered in their regular rating review and update processes.
- 123 Another participant from other industries mentioned that for their financial services business historical information was updated periodically to review the validity of the probability of default and loss given default procedures to perform back-testing. This meant that the latest available information was used from the past to conclude on the future. Generally, future economic conditions could only be assessed by observing micro and macroeconomic trends and therefore it was difficult to forecast future economic conditions with a sufficient certainty.
- 124 This participant also reported that there were issues for the industrial part of their business as they used the incurred loss model with the objective evidence criteria of impairment under current IAS 39 for trade receivables. Therefore they did not have other indicators and information to assess the expected credit loss. It was felt that it was difficult to implement a model for each trade receivable and would prefer a general loss allowance generated from historical information.

Significance of the 'day-one' loss

- 125 Eight participants indicated that the day one loss would be significant compared to the current allowance under IAS39. Seven participants indicated that this would not be significant, while seven participants did not answer the question with some of these indicating that their assessment was not yet complete.
- 126 Of the eight participants indicating this amount as being significant seven were from the banking industry and one from the insurance industry. Of those who indicated it was not significant three were from the banking industry, one from Insurance and three from other industries. Of those who did not answer five were from the banking industry and three from other industries.

Total impact on the level of allowances

- 127 Fifteen participants did not provide an answer to the question. Seven participants did provide an answer, but not all of these provided a detailed answer.
- 128 Three participants indicated that they would use the transition relief for measuring expected losses while four participants indicated that they would not use the transition relief. Those who intended not to use the relief were all from the banking industry, while for those intending to use the relief two were from the banking industry and the other from the insurance industry.

- 129 One participant from the banking industry indicated that for some of their portfolios the increase in the allowance under the ED would be 0 to 25% higher, 25 to 50% higher for some portfolios and up to 75 to 100% higher for some portfolios. This final category was in respect of loans to central and regional government as well as loans to credit institutions and investment firms.
- 130 Another participant from the banking industry indicated a range of portfolios which were affected by higher allowances which were in the ranges 0 to 25%, 25 to 50% and 50 to 75% higher than under IAS39. There were quite a few portfolios which were in the range of greater than 100% and these covered loan portfolios with debt securities (using internal ratings), loans to credit institutions and investment firms and loans secured by real estate properties.

Reliance on initial credit quality

- 131 Five participants indicated that they relied on information about initial credit quality in doing their analysis. Another five participants indicated that they did not rely on the initial credit quality at recognition of the financial asset. Twelve participants did not provide an answer.
- 132 A participant in the banking industry who did not rely on the initial credit quality mentioned that they made assumptions based on the age of each loan to assess the probability of a significant deterioration by compiling a migration matrix. Another participant who did not rely on the initial credit quality indicated, that they would not base their assessment on the existence of a significant deterioration in a pure comparison between initial credit quality and current credit quality, but rather perform a more qualitative assessment using credit risk indicators that would indicate the existence of a significant deterioration in credit quality.
- 133 A participant in the banking industry who relied on the initial credit quality at inception stated that they compared initial credit quality and any deterioration when managing credit risk currently. Another participant in the banking industry mentioned that in the context of the analysis performed, they relied on the initial credit quality estimated through a statistical approach that was based upon the Basel II Pillar II approach using multi-year transition matrices.

Ability to build an expected credit losses model compared to the 2009 ED

- 134 Fifteen participants noted that based upon the requirements of the ED they were able to build their internal expected credit losses model, while this was not the case when they considered the requirements of the 2009 ED. One participant said it did not. Six participants did not provide an answer.
- 135 A participant in the banking industry commented that the new ED was operationally easier to implement as it build on existing processes and risk management practice. Additionally, the decoupling of expected loss recognition from interest revenue further resulted in a significant reduction of complexity and operational burden. It was acknowledged that the 2009 ED was from a conceptual point of view the best solution to reflect the economics of lending and that the current model contained simplifications following preparers' feedback while still trying to keep the spirit of the 2009 ED intact.
- 136 A participant from the insurance industry stated that the 2009 ED was conceptually sounder, however, it was acknowledged that, the operational complexities of implementing such a model were excessive.

Requirements fairly reflect the performance of lending and investing portfolios over time

- 137 Nine participants found that the requirements allowed them to reflected the performance of lending and investing portfolios over time. Six participants thought it did not allow them to do so.
- 138 One participant from the banking industry who found that the requirements reflect the performance of lending, indicated that it believed that the ED more fairly reflects performance than other approaches which have been suggested by the IASB or FASB to date. Another participant from the banking industry mentioned that they were positive from the perspective of consistency with the metrics used in credit risk management. It was also mentioned that the FASB model recognised a loss allowance at an amount equal to lifetime expected loss at initial recognition and consequently did not reflect in any way the performance of their lending portfolios. Additionally the migration from one year to lifetime expected loss did not correspond to current management practices.
- 139 A participant from the banking industry who found that the requirements did not reflect the performance of lending stated so because adopting these requirements implied that the bank incurred a day-one loss for loans in stage-1, which they considered to be a buffer. Furthermore when a transaction moved to stage two it suffered a provisioning cliff effect which was more relevant than the increase in credit risk.
- 140 A participant from the insurance industry, who found that the requirements allowed them to reflect the performance of the lending activities, stated that compared to IAS 39 the requirements would better reflect the performance of their investing portfolio if the realised loss from defaults would on average be greater than or close to the expected loss allowance. In this instance the allowance represented a type of “risk buffer”. However, in case the allowance clearly overstated credit losses, the requirements could also result in misleading information instead of fair presentation of investing activities.

Application Guidance

- 141 Many participants indicated that the application guidance was neither clear nor operational. Six participants found the application clear and operational. Four participants did not answer the question.
- 142 One participant from the banking industry who considered the guidance to be clear without being overly prescriptive, except with regards to the wide variation in discount rate permitted. Another participant from the other industries felt that as far as their kind of portfolios were concerned they believed that the application guidance was clear and gave enough operational guidance.
- 143 A participant from the banking industry who found the application guidance not clear clarified that tracking probability of defaults as required by the ED would imply a highly complex and costly implementation, and was not aligned with the actual risk management. It was suggested that paragraph 8 and B14-B15 of the ED which required this tracking be modified to allow for other ways of assessing credit deterioration using by way of example ratings, delinquency information, behavioural scores or qualitative information.
- 144 A participant from the insurance industry discussed the new impairment model and indicated that it should be based upon the application of management judgment. The analysis performed should be a review of all available information including external ratings and internal evaluations. The examples and reference to ‘low credit risk’ was considered helpful, however, to ensure that the standard remained

principle based it was important that the standard was not misinterpreted as setting bright line thresholds.

- 145 A participant from the banking industry suggested allowing each entity to rely on its own evaluations to design and build a model compliant with the proposed standard.

Main benefits of the new ED compared to IAS 39

- 146 The majority of participants commented that the ED had benefits compared to the current standard. Most participants indicated that they saw benefits from the ED while some participants did not so and expressed concerns or indicated that there were disadvantages from the ED. Five participants did not provide an answer.

- 147 An overview of the benefits participants identified in the ED were the measurement of future credit loss expectations in profit or loss, the closer link to existing risk management practices, credit losses being recognised earlier, being more capable of implementation compared to previous proposals and a better alignment between regulatory and financial reporting. A few of the participants mentioned the following benefits:

- (a) Deal with ‘too little too late’ problem of IAS 39;
- (b) The closer link to existing risk management practice will improve transparency;
- (c) The ED allows a closer link to regulatory processes;
- (d) Every financial asset is assigned an allowance for credit losses;
- (e) The incurred but not reported definition under IAS 39 is complex and difficult to apply consistently;
- (f) Future expectations are reflected in the level of allowances for credit losses, and the measurement and representation of credit losses expectations will be improved;
- (g) The proposals is best placed to meet the criticisms of IAS 39 and more capable of implementation than previous proposals; and

- 148 A few of those participants who did not see benefits mentioned the following disadvantages or specific concerns about the ED:

- (a) Methodologically complicated compared to IAS 39;
- (b) Countercyclical effect of the new standard;
- (c) The proposals are more complex and more subject to judgement than IAS 39;
- (d) No benefits in using the expected loss approach with lifetime-probability of defaults; and
- (e) The pro-cyclical impacts on profit or loss are deemed to be critical.

Overall operational difficulty

- 149 The assessment of the overall operational can be found in the table below.

Table 5 Participants' assessment of the overall difficulty

Individual Factor	High Impact	Moderate impact	Low impact
Tracking credit quality	11	6	1
Estimating credit losses	8	7	2
Estimating probabilities of default and loss rates	7	8	3
Significant credit deterioration criterion	9	7	2
30-days past due rebuttable presumption	1	6	9
Investment grade practical expedient	1	5	11
Access to sufficient data	10	8	1
Discounting expected credit losses	9	6	3
Disclosures	14	4	–
Transitional provisions	6	8	3

Overview of the implementation costs

150 Most of the participants, mainly from the banking industry, noted that they expected the costs of implementation to be relatively high. In addition, most participants, mainly from the banking and the other industries, noted that they expected the on-going costs to be relatively moderate. The following table summarises the how participants assessed the implementations cost of the ED:

Table 6 Cost assessment

	High Impact	Moderate impact	Low impact
One-off costs	13	2	1
On-going costs	6	8	2

151 Six participants did not indicate the cost impact as they had not completed their cost assessment yet.

152 None of the participants provided an estimate of the amounts involved regarding the one-off costs and all the information provided by participants was qualitative in nature. A detailed table is provided below which lists the one off costs mentioned by participants.

153 Nine participants did not provide specific answers, however, three of those participants indicated that there would be significant on-going costs involved or that on-going processes were complex. Two were from the banking industry and one participant from the insurance industry. Five participants provided no answer and one participant indicated that on-going costs were low to moderate and further assessment was required. Of these nine participants six were from the banking industry, two from the insurance industry and one participant from other industries.

154 The following table summarises the main types of costs that participants expect to encounter in order to implement the proposals in the ED:

Table 7 –Types of one-off costs and ongoing costs identified

One off costs	Ongoing costs
<ul style="list-style-type: none">• Significant IT costs including development of the model and systems, tools and processes, rollout• Significant educational costs• Significant costs relating to data collection from numerous countries and investment for data availability• Changes to internal and external financial reporting• Alignment with internal credit risk management• System developments to obtain historical data to compute provision matrix for expected credit losses• Definitions of roles and responsibilities and design of new workflows• Implementation of the disclosure requirements	<ul style="list-style-type: none">• Complex ongoing processes and procedures• Detailed calculations and disclosures• IT effort to maintain systems and manage data, models and processes• Audit and regulatory costs• Tracking scenarios and forecasts require ongoing system development and training

APPENDIX A – LIST OF PARTICIPANTS IN THE FIELD-TEST

Participant	Industry	Country
Allianz	Insurance	DE
AXA	Insurance	FR
Barclays	Banking	UK
Bayerische Landesbank	Banking	DE
BBVA	Banking	SP
BCEE Lux	Banking	LU
BIL	Banking	LU
BNP Paribas	Banking	FR
BPCE	Banking	FR
Deutsche Bank	Banking	DE
HSBC	Banking	UK
Intesa San Paolo	Banking	IT
La Caixa	Banking	SP
Lloyds	Banking	UK
Mediobanca	Banking	IT
Standard Chartered	Banking	UK
Alcatel Lucent	Other industries	FR
Daimler	Other industries	DE
Telecom Italia	Other industries	IT
Undisclosed	Other industries	–
Unicredit	Banking	IT
Volkswagen	Other industries	DE

APPENDIX B – FINDINGS FROM THE WORKSHOP ON 10 JUNE 2013

Assessment of a significant increase in credit risk

- 1 Several participants found that, in assessing the 12 month and lifetime expected losses, more emphasis should be given to the use of qualitative analysis and delinquency information.
- 2 The reduced comparability which would result from this could be handled through enhanced disclosures. However, disclosure requirements should remain balanced.
- 3 Participants found the change in the probability of default should be expressed as an objective rather than as an absolute 'shall' and asked to align the standard (paragraph 8) with its application guidance (paragraph B21)

Modelling the IASB ED

- 4 Participants agreed that the standard should remain principle driven. They noted that assessing changes in the probability of default should be the objective, but other approaches should be allowed such as delinquency information and watch-lists.
- 5 Data inadequacy existed and could be resolved with management judgment. The 30 days past due criterion should be used only for retail portfolios. Entities should be encouraged to use other information.

Operational simplifications

- 6 To demonstrate the 'low credit risk' grade the ED used 'investment grade' as an example only. However, participants found that while the example could be retained, it should not be interpreted as a hard trigger.
- 7 Additionally, participants asked for a clarification that a decrease below 'low credit risk' should not automatically trigger recognition of lifetime expected credit losses.

Discounting

- 8 Participants found that discounting should not be required for the calculation of 12 month expected losses.
- 9 The practical expedient to choose a discount rate between the risk free rate and the effective interest rate was welcomed but should not be interpreted too narrowly. Participants found that any reasonable discounting methodology which took into account the time value of money and credit risk practices should be allowed to discount expected credit losses.
- 10 Participants expected the results of the field-test to be instructive on this point.